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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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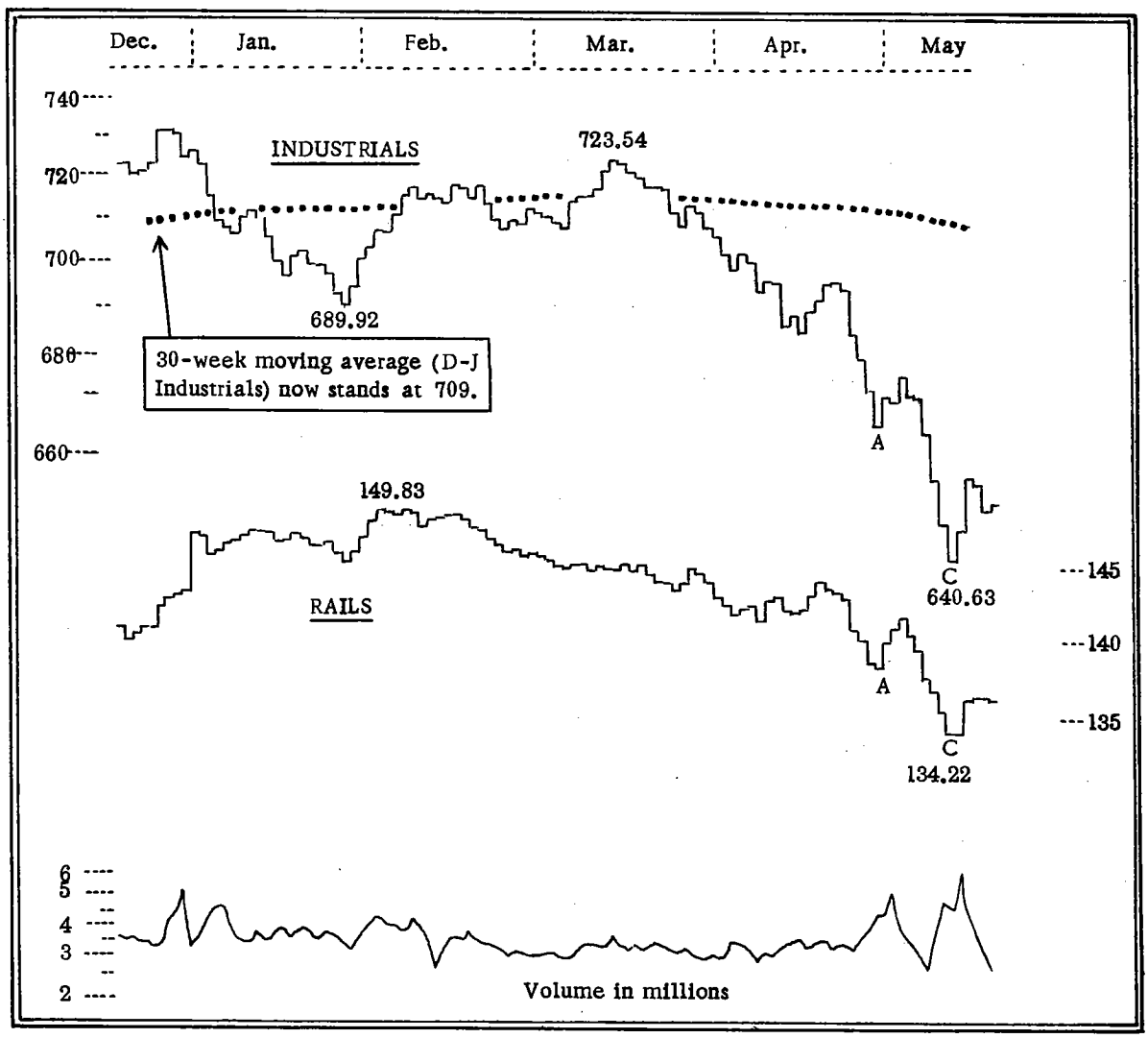
THE MARKET On May 1 (day following point A on chart) the market opened badly. By 12 noon Industrials were down (on an hourly basis) to 659.95 , whereupon heavy buying entered the market and the Industrial Average closed the day at 671.24. This was a classic "one-day reversal". Following a rally, the two Averages declined to "test" the preceding lows at A. Volume on the decline shrunk drastically to 2.5 million shares. This extreme "dullness" was followed by a violent break which by May 11 saw the Industrial Average close at 640.63 (point C).

The break following dullness in volume caused this writer to "sit up and take notice". In fact it caused me to re-read Robert Rhea's dissertation on the implications of volume. "The old maxim of Wall Street, 'Never sell a dull market', is bad advice in a major bear market. The time to sell in a bear market is when volume dries up after a sharp rally: activity on declines indicates a continuance of the bear trend." And again: "Rallies in a bear market are sharp, but experienced traders put out their shorts again when the market becomes dull after a recovery." (Robert Rhea).

On May 14 another "one-day reversal" occurred. The market opened violently lower on heavy volume. By 11 A.M. Industrials touched 631.51. Then, on a 34 minute late tape, the market turned to the upside to close the day at 646.20.



The advent of two one-day reversals within a period of ten trading days was extraordinary. Opening the volume "Technical Analysis of Stock Trends" by Edwards and Magee, I read: "Remember, a one-day reversal is not a dependable major trend indicator. Selling climaxes do not normally occur at the final bottoms of bear markets. Only one primary downtrend in all the records has, in fact, ended with the first panic phase, that being the five-month bear market of

 1938-39, which was followed by an equally short bull market."

May 16 and 17 saw the market drift lower on diminishing volume. If, on the current decline, one or both Averages can hold above May 11 lows at C (Industrials 640.63, Rails 134.22), there is a possibility of a full 1/3 to 2/3 correction of the decline since December, 1961. Conversely, a breaking of the C lows on expanding volume will signal a continuation of the bear leg. In that event, I would not be surprised to see more downside violence than was seen at either point A or point C.

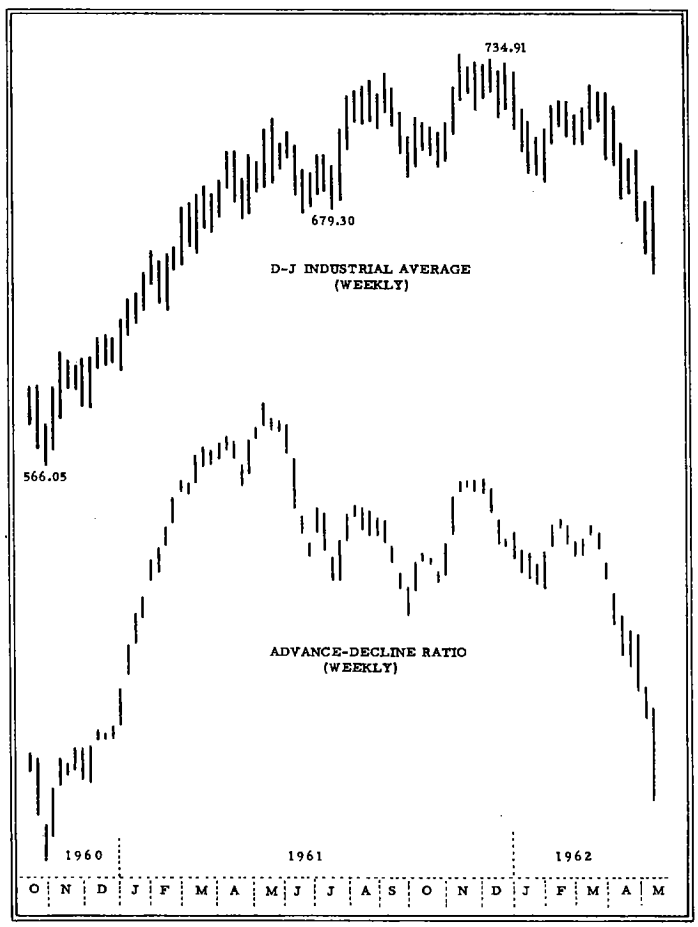
THE BIG PICTURE From June 13, 1949 to May 10, 1962 (see Letter 180) the Averages provided four signals that conformed in structure with the classic Dow Theory bear signal. The declines that followed the bear signals of 1953, 1957, and 1960 were not substantial. Therefore, whether we label the 1953, '57, and '60 action as "baby" bear markets or severe secondary reactions is rather academic. The important thing is that following each decline, a great deal of technical strength appeared. Moreover, in conjunction with this technical strength, each decline held above the 50% level of the preceding major bull market advance.

In 1953 the reaction held a full 23 points above the 50% level (see chart in Letter 180). In 1957 the decline held 21 points above the 50% level. In 1960 the decline held only 14 points above the 50% level. Subsequent to each successful " testing" of the halfway point of the preceding major advance, the Industrials turned up and embarked on an advance which eventually took the senior Average to new historic highs.

Again referring to the chart in Letter 180, it is interesting to note that the reactions of 1953, 1957 and 1960 (and 1946 for that matter) each touched bottom in an area well above the highs of the preceding major advance. Thus the 1953 low held above the 1946 peak, the 1957 low held above the 1953 peak, and the 1960 low held above the 1957 peak.

On May 10, 1962, however, we witnessed the first major decline to break below the 50% level of the preceding advance. This decline also succeeded in violating the long-term trendline which extends from 1949. And, significantly, the 1962 decline (for the first time) carried into territory below the peak of a preceding bull swing. Thus, on the most recent decline the Industrial Average has actually entered the area of the 1957-60 advance. This is the first time since 1942 that a downward movement has entered into minus territory. In other words, the Industrial Average is now below the peak of the advance that began in 1957 and ended (at 685.47) in January, 1960. Seen from another viewpoint, three years of action (for the first time) has failed to tack any yardage on the senior Average.

A glance at the weekly chart of the Industrial Average and the advance-decline ratio (see chart at right) further underscores this analysis. As measured by the ratio of advances and declines, the action of the past week took us back to November, 1960. Considering that the upward movement started one month earlier (in October, 1960), the advance-decline ratio is saying that the general market is only slightly above the starting point for the entire advance. Such action on the part of the advance-decline ratio has not been seen during the entire broad upward move that began in April, 1942.



The above situation allows for either of two views: (1) the decline from December, 1961, has been so severe and so violent that the market would now seem in position for a major correction--a correction that could retrace one-third to two-thirds of all the ground lost. Or (2) the severity of the action since December, 1961, has damaged the price structure and the internal structure of the market so badly that the bull case is reduced to "playing" possible major corrections against a primary bear trend. But buying into bear market reactions is a dangerous procedure. Writing during the bear market of 1937, Robert Rhea noted: "...while many of our clients liquidated everything at gratifying levels, a large percentage still seems to have retained at least part of their holdings. Perhaps 60% of them are impatient to buy on dips. This is the kind of practice that broke so many people in 1930 and 1931."

This writer does not pretend to know when the next broad upward move (correction) will begin. Any rise could be the beginning of a major retracement or an upward "fizzle". However,

on the basis of evidence presented in this and the last Letter (180), my own opinion is that the bullish "play" is now reduced to nothing better than a gamble.

PSYCHOLOGY DURING MAJOR DECLINES It is almost axiomatic that when a market reverses from bull to bear (or from bear to bull), the public fails to see the daily and weekly action as part of a major trend. For instance, during a primary bear leg each successive minor decline is considered to be the "last one", and each new drop is seen as "taking the market down too far" in view of the prevailing economic conditions.

On the final decline of a primary bear leg the public invariably concludes that "this is really part of a continuing picture." There is a rush to get into cash, panic market conditions (often with accompanying heavy volume) may prevail, and such expressions as "this is only the beginning", and "they'll go down another 100 points" may be heard in boardrooms. Such panic psychology sets the stage for a full (upward) correction. Frequently, the true termination of a primary bear leg is accompanied by economic news of the blackest variety.

The final major downward leg, however, usually ends differently than any of the preceding bear legs. The last leg is often accompanied by signs of "exhaustion." This includes extremely low volume, resistance to decline by many stocks, and an investor sentiment that can best be described as one of "hopelessness."

The current leg must be considered the second leg in a bear market that began for Industrials in December, 1961. For the record, a bear market may have two to any number of downward legs. Thus, the bear market of 1937 had only two legs, while the bear market of 1929-32 had eight distinct legs (a number never seen before or since).

AN OBSERVATION Leading magazines and newspapers throughout the nation have done their best (and I believe they are sincere) in "explaining" the reasons for the market decline. In the majority of instances, they have labeled this a "decline in confidence" brought on by the Kennedy administration's policy of interference with business -- and brought to a head by the Kennedy-steel industry altercation. If past experience means anything, I suggest that subscribers refrain from accepting pat analysis and conclusions regarding the "reason" for the market's action. This observer strongly suspects that the reasons for the decline go far beyond events of recent weeks; further, that they go beyond even Kennedy and the "New Frontier." The advance-decline ratio turned down in April, 1961, eight months before the Industrial Average recorded its final peak. The Rail Average turned down in October, 1961, two months before the Industrial peak. The decline in all three indicators preceded by many months the headline articles regarding the steel-pricing argument. What the market was discounting as each indicator turned down was probably a great deal more fundamental than a dramatic fight between steel and the President. What the market was "saying" last week when it broke the 650 level may only be known many months from the time of this writing.

A LETTER FROM A SUBSCRIBER (May 15): "I am wondering if you feel that the ability of the Rails to hold above their July, 1961 low, 133.49, will still present the major non-confirmation you pointed out a possibility of in your Feb. 8th letter- No. 170.

It seems to me, taking the Rail low as the main secondary point, we have so far seen a normal secondary percentage reaction in both averages, namely 50% for Industrials and about 65% for rails, well in line with the Dow Theory range for secondaries.

With the exception of the 50% principle, other factors would seem to support the view that ability of one or both averages to hold at the recent low points would negate the existance of a bear market."

ANSWER: New highs were struck by the Rail Average following the 133.49 low. This action erased the significance of the preceding 133.49 Rail low. The bear point was 140.66 as far as Dow's Theory is concerned.

It is true that so far (1) bank credit figures are bullish, (2) we have not had liquidation-type volume. But with the 50% level broken, I feel that something fundamental has "cracked" in this market.

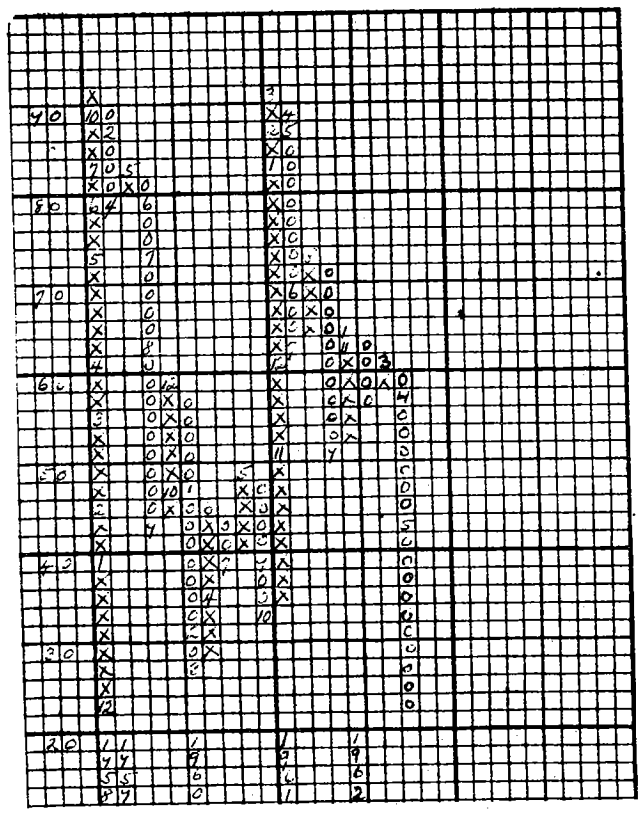
There is always room for error -- until an actual "crash" removes the last doubts regarding the direction of the primary trend. But as stated in the last Letter, there must be some level at which credence is given the bear argument. I feel that that level has been reached.

My own opinion is that the best we will now see is a 1/3 to 2/3 correction of the entire decline. Had the 50%

level held, I would have looked for a possible rise to new highs on the Industrial Average. It is well to remember, also, that the normal 1/3 to 2/3 correction could come from these or lower levels. The decision to ride them down is a difficult one. I choose not to take that course (perhaps sleep is worth more to me than the minor losses which I sustained).

AN INTERESTING STUDY My "pen pals" at Chartcraft, Larchmont, N.Y., run a useful study. Charts are kept of the price action of 76 different industrial stock groups (Standard & Poor's statistics). Weekly tabulations are made of the percentage of these 76 groups which maintain bullish patterns. This is actually a "breadth of the market" study. Historically, when the bullish percentage drops below 50% we can say that a significant "top" has been formed. A few weeks ago the bullish percentage dropped below 50% and by last week this percentage had been reduced to 22.3%. As seen on this "point-and-figure" chart the bullish percentage of 22.3% is below that of 1960 (28% bullish at the worst in 1960). The X's on this chart indicate upmoves, while the O's indicate declines.

BULLISH PERCENTAGE CHART



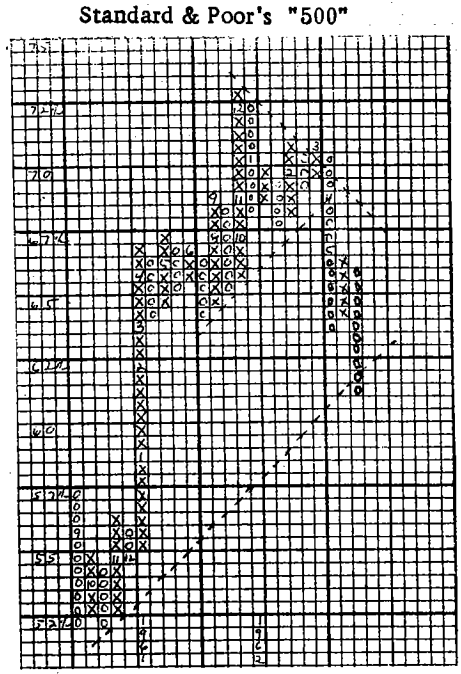
In line with this study, the point-and-figure chart of the Standard &Poor's "500 stocks" now shows a penetration of its major ascending trendline. This implies severe damage to the general market; it also implies that the broad upward bull momentum has been broken.

NOTE A number of subscribers have asked about books. I enclose the latest list of books available from this office. "Public Participation in the Stock Market" by Sloan Wilson (an old subscriber) has just been published. It is an excellent little volume, and it presents some new studies which I found completely fascinating (as well as very helpful).

FOREIGN MARKETS Iain Fraser of Traders Research Ltd., 159 Bay St., Toronto 1, Ontario, is now publishing weekly charts of stocks from the Common Market nations (plus Great Britain). The charts are most interesting, particularly in conjuction with the foreign stock average which I keep at this office. Markets in West Germany, Holland and Italy now look distinctly bearish. England (according to my English Dow Theorist friend, J. F. Danson) has never given a bull signal. Interestingly, the best looking market in Europe belongs to long-suffering France.

LATE MARKET NOTE: On Friday, May 18, volume decreased to 2.49 million shares as most stocks worked fractionally lower. New daily lows increased on Friday to 102 from 81 on May 17 and 31 on May 16. The writer wondered if the situation might not be a repetition of the dullness which preceded the late April break. As this is written (Monday, May 21 -- 11 A.M. New York time), the market is slightly lower with volume actually running behind Friday's low level. The "test" of the lows at C is now in progress. The ability or inability of the Averages to hold above the C levels (see chart on page 1) will obviously provide the first clues to the near-term picture.

Standard & Poor's "500"



STOCK NOTE Of 56 "key" stocks which are watched with particular care at this office, only 2 are now holding above their 10-week moving average (despite last week's rally). These two are Dome Mines and Campbell Red Lake (both golds).